ACCEPTANCES

Their Importance as a Means of Increasing and Simplifying Domestic and Foreign Trade

Prepared and Issued by

The American Exchange National Bank

NEW YORK

FOREWORD

In presenting the subject of Acceptances for the consideration of the business men of the United States, we do so with a feeling of pride in the part that this bank has played in the commercial development of our country.

The American Exchange Bank was organized in 1838, antedating by many years the National Banking System. In 1865 it was converted into a National Bank, and it was one of the first banks to enter the Federal Reserve System.

George S. Coe, who served as president of this bank from 1860 to 1894, clearly foresaw the time when material changes in our banking system would be needed. In 1881 Mr. Coe predicted the change from bond-secured currency to currency secured by commercial assets and then declared that, after all, the latter was the most natural, useful and reliable basis. He also said:

"The condition of a bank is soundest and its power most effective when its assets are composed of notes, drafts and obligations of the people—the title deeds to those commodities or articles most demanded for the subsistence and necessities of men, and for their comfort and convenience—together with a due proportion of ready money, into which all these things are exchangeable.

"Commercial banks are the oldest and safest financial institutions in the United States, or in the civilized world. They have, in all nations, outlived the changes of the governments that formed them, and they have uniformly given support to states in their greatest emergencies, rather than received it, because commercial

banks are the embodiment and the reservoirs of the active industrial power of the people. Always they are greater than the State itself."

The American Exchange National Bank, having at all times taken an active interest in the commercial development of the country, desires to do its utmost to encourage the use of trade acceptances in the United States, because it believes that their general employment will add materially to the prosperity of the individual, as well as to the prosperity of the nation itself.

AMERICAN EXCHANGE NATIONAL BANK.

New York City, April 25, 1916.

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FORM No.1.

TRADE ACCEPTANCE

No.______ ______________________ 191__ $__________

Thirty / Sixty / Ninety days after date / sight pay to the order of OURSELVES

______________________________________ Dollars

The obligation of the acceptor hereof arises out of the purchase of goods from the drawer.

To______________________

____

Accepted ______ 191__

Payable at ______ (Designate bank or place of payment) ______ (Signature of Acceptor)

FORM No. 2.

TRADE ACCEPTANCE

No.______ ______________________ 191__ $__________

______________ after ______________ pay to the order of

____

______________________________________ Dollars

The obligation of the acceptor hereof arises out of the purchase of goods from the drawer.

To______________________

____

Accepted ______ 191__

Payable at ______ (Designate bank or place of payment) ______ (Signature of Acceptor)

Trade Acceptance Forms Prepared by Federal Reserve Bank of Cleveland, Ohio.

New York April 15 1916

Ninety days after Sight

Pay to the order of Ourselves

Twenty Thousand 00/100

for value received and charge the same to account of

The American Exchange National Bank

New York

John Doe & Co

No.

ACCEPTED APR 15 1916 DUE

THE AMERICAN EXCHANGE NATIONAL BANK NEW YORK CASHIER

Official Signature

Form of Bank Acceptances

Chapter I

CREDIT FUNCTIONS AND INSTRUMENTS

"In the primitive ages of commerce article was exchanged for article without the use of money or credit. This was simple barter. As civilization progressed, a symbol of property—a common measure of value—was introduced to facilitate the exchanges of property. This may be iron or any other article fixed by law or by consent, but it has generally been gold or silver. This certainly is a great advance beyond simple barter, but no greater than has been gained in modern times by proceeding from the use of money to the use of credit.

"Commercial credit is the creation of modern times, and belongs in its highest perfection only to the most enlightened and best governed nations.

"Credit is the vital air of the system of modern commerce. It has done more—a thousand times more—to enrich nations than all the mines of all the world. It has excited labor, stimulated manufactures, pushed commerce over every sea, and brought every nation, every kingdom and every small tribe among the races of men to be known to all the rest. It has raised armies, equipped navies, and, triumphing over the gross power of mere numbers, it has established national superiority on the foundation of intelligence, wealth and well-directed industry.

"Credit is to money what money is to articles of merchandise. As hard money represents property, so credit represents hard money, and it is capable of supplying the place of money so completely that there are writers of distinction who insist that no hard money is necessary for the interests of commerce. I am not of that opinion. I do not think any government can maintain an exclusive paper

system without running to excess, and thereby causing depreciation.

"I hold the immediate convertibility of banknotes into specie to be an indispensible security for their retaining their value. But consistently with this security, and indeed founded upon it, credit becomes the great agent of exchange. It increases consumption by anticipating products, and supplies present wants out of future means. As it circulates commodities without the actual use of gold and silver, it not only saves much by doing away with the constant transportation of the precious metals from place to place, but also accomplishes exchanges with a degree of dispatch and punctuality not otherwise to be attained.

"All bills of exchange, all notes running upon time, as well as the paper circulation of the banks, belong to the system of commercial credit. They are parts of one great whole. We should protect this system with increasing watchfulness, taking care, on the one hand, to give it full and fair play, and, on the other, to guard it against dangerous excess."

This masterly summing up of the functions of credit and its instruments might have been uttered but yesterday, instead of more than four-score years ago. It is from a speech by Daniel Webster, in the United States Senate, March 18, 1834.

Acceptance an Important Credit Instrument

Credit is the lifeblood of business. One of the principal channels through which it flows is the acceptance, or time bill of exchange.

The system of credit based on acceptances has been very widely developed through long usage in England, France and Germany. It is so comparatively new in the United States that it is not yet generally understood. Its fields of employment here, however, are broadening rapidly, and it seems likely to become, before very long, one of our chief credit instruments. This is the opinion of the Federal Reserve Board, as expressed in its circular of February 8, 1915:

"The Acceptance is still in its infancy in the field of American banking. How rapid its development will be cannot be foretold, but the development itself is certain."

Trade Acceptance Defined

The term "Trade Acceptance" is defined by the Federal Reserve Board in its circular of July 15, 1915 as

> "a bill of exchange...... drawn to order, having a definite maturity and payable in dollars in the United States, the obligation to pay which has been accepted by an acknowledgment, written or stamped, and signed, across the face of the instrument, by the company, firm, corporation or person upon whom it is drawn; such agreement to be to the effect that the acceptor will pay at maturity, according to its tenor, such draft or bill without qualifying conditions."

A bill of exchange is defined by the English Bills of Exchange, Act of 1882, as "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a certain sum in money to, or to order of, a specified person, or to bearer."

A negotiable bill of exchange, or acceptance, therefore, is a written order whereby A commands B to pay to C, or to his order, or to bearer, a sum of money absolutely and at a certain future time. A is the drawer, B the drawee, and C the Payee. If B agrees to obey the order upon him, he writes the word "Accepted" across the face of the bill and signs his name below this word, together with the date of the acceptance, the date that it is payable, and the place. Thereupon B becomes and is known thereafter as the Acceptor, and the document is known as an Accepted Bill, or Acceptance. Such instruments are two-name paper, since they carry the names of both the Drawer and the Acceptor. If the Payee chooses to transfer the paper and all his rights under it to some other person, he endorses it.

Acceptances Differ from Notes and Drafts

An acceptance, or time bill of exchange, therefore, is an order. Its acceptance is equivalent to the promise to pay that is contained in a promissory note. The promissory note, however, is not intended to transfer funds, but to settle debts and borrow money. A

note is drawn *by* persons. An acceptance is drawn *on* persons. The acceptance consequently performs an entirely different function than the promissory note. Each has its distinct field in the world's financial affairs.

The acceptance differs also from the commercial draft. The commercial draft, with bill of lading attached, may be drawn at sight, or may be made payable at a certain time after sight. This enables the title to the goods covered by the bill of lading to remain vested in the seller, the drawer of the draft, or the person to whom the bill of lading may be endorsed, until the draft is paid. Another form of commercial draft is the sight draft for collection, which is drawn on buyers who have been previously sold on open account. It has been generally used as a means of collection when ordinary means have failed to produce payment. The trade acceptance, on the other hand, is an acknowledgment of an obligation and a promise to pay it on a certain date.

Fundamental Purpose of Acceptances

The time bill of exchange, or acceptance, has a fundamental purpose which neither the promissory note nor the commercial draft possesses. That purpose is to facilitate the mutual offsetting of debts between individuals, as well as nations. Acceptances, or time bills of exchange, pass from hand to hand the same as money. They serve the same purpose as the transfer of gold itself in the cancellation of debts. Abroad they have long been considered as the easiest and cheapest form of credit instruments.

Economists regard acceptances as a sort of special currency. Such really has been their use for the last two centuries in the Old World, where acceptances have been employed between business houses in the settlement of accounts. They circulate among banks which buy and resell them according to their needs until they are negotiated to the central or Government bank of the country. The provisions of the Federal Reserve Act, their interpretations by the Federal Reserve Board, the regulations issued by it and the different State laws recently enacted, indicate a purpose to make bank acceptances an asset quickly and easily convertible into cash and to constitute an additional reserve to the banks carrying them.

Chapter II

THE ENGLISH CREDIT SYSTEM

In England and Germany the bank acceptance is the principal form of credit. In France the individual acceptance is more generally used.

London became the center of international payments in export trade through England's being the chief commercial carrier in the early stages of the development of Europe's export markets. European traders were quick to see the convenience and advantage of receiving their payments in one currency rather than in the miscellaneous currencies of the different over-sea markets. Thus, London became not only a clearing house for international settlements, but also a central place of deposit for bankers and merchants all over the world.

This created an immense revenue for England. For very many years London has collected a heavy toll from the financing of practically all the exports and imports between the United States and other countries. The proceeds of a shipment of machinery or merchandise, for example, from St. Louis, Chicago or New York, destined to some point in South America, would be in the form of a draft drawn on London. For the acceptance of this draft the London banker would charge a round commission. A bale of raw silk imported from Japan by a house in New York would be paid for by the seller in Japan drawing a bill on London. It was estimated, before the Federal Reserve Act went into operation, that American exporters and importers were paying London some $10,000,000 a year for such services.

"Dollar Exchange" and Sterling

The fundamental reason for this was that the bank acceptances in pounds sterling could always be converted into the local currency of any country at a close rate of exchange, whereas a draft in dollars on New York would have no such markets. To-day this condition is changing rapidly, and "dollar exchange", in many of the world's marts, is being sought instead of sterling because its purchasing power as expressed in local currency is greater than sterling exchange. This gives the American exporter an advantage that he has never before enjoyed—that of dealing with foreign buyers and sellers in his own domestic currency, thereby saving the extra cost of exchange on London and other expenses.

England Leads in International Banking

While other nations have become important factors in the ocean carrying trade, and thus are less dependent upon the great and long-established facilities of Great Britain for the transportation of merchandise across the seas, they have been less successful in their attempts to deal directly with their international customers and to eliminate London as a center of financial intercourse with the export markets of the world. Germany, for example, by the organization of German merchants in many foreign markets, succeeded in establishing a standing for German currency abroad and a certain volume of direct financial intercourse. Yet the German exporters and importers still relied largely on London in their overseas settlements. England is still at the head of international banking, and has developed the standard forms of dealing with the financing of shipments to and from over-sea markets. The English banks engaged in foreign banking have divided their world territory on the basis of commercial usages and prevailing business conditions. East and West are sharply differentiated, and the British dominions with a white commercial population are catered to by special banks. Within these three great divisions there is a further specialization by countries. Almost all of these banks have headquarters in London.

The London Money Market

The heart of the London money market is the Bank of England. Then there are 82 great joint stock banks, with more than 7,000 branches, employing nearly $700,000,000 in capital and deposits of more than five and one-half billions; 40 Colonial banks, with about $750,000,000 out on call or short time loans; 30 Foreign banks, which, together with the Colonial banks, practically cover the world with their branches; finance houses that make a specialty of accepting bills growing out of imports and exports; stock brokers; bill brokers; the Stock Exchange and its affiliations; the insurance companies, and the private lenders, who in the aggregate compose the great money-holding interests of London and what is ordinarily known as the London money market.

The Bank of England does not buy bills payable abroad. It requires two British names to the bills it purchases, and one of these must be the acceptor. The average length of time is 40 to 50 days, and the average amount £1,000.

Theory of the English System

The London money market is regulated principally by the open market operations of the bankers and brokers. If they consider that the commercial public is over-trading, they check this tendency by ceasing to buy bills. The Bank of England, while it is not obliged to buy all bills that are offered, is accustomed to purchase all that comply with its requirements. The whole theory of the English system is based on the keeping of balances with the Bank of England which are immediately convertible into cash, and the rediscounting of paper with the bank to obtain cash. The Bank of England rate of discount, which is fixed at the weekly meeting of the Board of Directors and is published on Thursdays, moves up or down primarily in accordance with the law of supply and demand. If the demands are heavy and the supplies of funds are low, the Bank increases its rate, which discourages borrowing. If the opposite condition prevails, the rate is lowered and borrowing is correspondingly stimulated.

Classes of English Bills

The two classes of bills or acceptances most largely dealt in by the London market are the "trade bill" and the "finance bill". The former is the result of one merchant selling goods to another. The seller draws on the buyer; the latter accepts the paper and returns the bill to the seller, who discounts it with his banker, or in the open market. The "finance bill" may represent exchange transactions; it may be for the purpose of carrying stocks of goods or securities, or in the anticipation of public loans; or it may be merely for accommodation. All finance bills, except the last named, when properly accepted, are eligible for rediscount by the Bank of England.

An essential part of these bills of exchange consists of bills drawn on bankers and accepted by them on behalf of customers in accordance with arrangements previously made. These "bank bills", while usually drawn to liquidate a commercial transaction, being accepted by a bank, become of a higher quality than mercantile acceptances, unless the latter are of the highest standing. These "bank" or "prime" bills are discountable at the lowest market rates. As the quality of the acceptance becomes lower, the rates for its discount rise in proportion to the possible risk. Generally, in the London market, the rate for trade bills is one-half of one per cent higher than for bank bills. In the English money markets close watch is kept on the amount of paper that is discounted by each of many thousands of firms. A house that appears to be overextending its credit is immediately made aware of the prevailing opinion by finding that its bills are selling below the market, or by the rates being raised for additional acceptances that it seeks to discount.

British Banks Governed by Traditions

It is this uniformity of security that has made possible the great public discount markets in London and the other leading financial centers of Europe. The English banks are legally restricted only in regard to bank notes—not as to their banking operations. They may open as many branches as they like; they may make any kind of advances they choose; the form of their invest-

ments or reserves is not governed by any Act of Parliament. In fact, the English bank uses its reserves whenever it considers it necessary. But although these British financial institutions seem to be a law unto themselves, they are actually governed by traditions, unwritten laws and public opinion. These forces keep them to a high standard of excellence and banking conduct.

Documentary Bills or Drafts

The bulk of payments through London foreign banks—those engaged particularly in international trade—is on the basis of documentary bills or drafts. These are drafts accompanied by bills of lading (full sets), invoice copy and insurance certificates. There are also so-called "clean bills", unaccompanied by such documents. The documentary drafts are drawn either against payment (d/p) or against acceptance (d/a). In the case of documents against payment, it frequently happens that the drawee pays before the draft falls due, if, for instance, he has resold the goods and needs the documents. In this case he receives an interest allowance, generally one per cent. below the central bank discount rate. Only partial advances are made in England to drawers on d/a drafts, and even these are not readily granted. These acceptances are more readily taken as collateral in loans or current accounts (overdrafts) or fully discounted.

These documentary drafts are usually drawn at from two to six months. The interest clause becomes more and more important as the distance and time of transit of documents between the shipping or receiving point of the goods and London increases. In London's dealings with the Far East, for example, the drawee has to pay, in addition to the face value of the draft, a certain interest until the approximate day of the receipt of the return funds in Europe. Such drafts contain this clause: "With interest at — per cent. per annum added thereto from date hereof to approximate due date of arrival of the funds in London."

The major portion of the business of the English banks in over-sea settlements is to take up documentary drafts, either for collection or for payment and advances thereon, or for acceptance on a commission basis. Occasionally the buyer on the other side

of the world has a credit with the bank in London, from which he authorizes the latter to pay invoices. This is the very best of all methods of financing shipments.

Safeguards of English Banks

The mere collection of drafts is only a very small part of the activities of British banks. Most London banks decline specifically to assume any liability for losses in connection with drafts; for documents that they handle; for merchandise that they may be called upon to take over; for the solvency or the remittances of their agents or correspondents, etc. While they safeguard themselves in every way consistent with sound and conservative banking principles, they undertake to use all care and diligence in the interest of their clients. As a rule, the English usage is that the customer shall assume the costs of collecting the drafts and of forwarding the proceeds to the seller. For this reason, the drafts either include these expenses in their face value or bear the clause "charges for collection to be added", or, on South Africa and Australia, "remitting exchange to be collected".

Advances on Consignments

In addition to partial or total advances on drafts, and even to their outright purchase, English banks make advances on consignments. In such cases the signature of the drawer of the draft forms one part of the security, and the goods the other. If the goods are to be turned over on acceptance of the draft, the bank retains a lien on the goods, which remain practically mortgaged to the bank until the draft is paid. The bank's rights are acknowledged in a "letter of hypothecation", which reads, in part, as follows:

"The above shipment, the goods and the proceeds thereof are to be treated as specially hypothecated to you by way of collateral security." Or, "the said goods in the meantime, and their proceeds or any part thereof, to be held by ———— in trust, on your behalf, for the payment of the said sum." The bank can instruct the

consignee regarding fire insurance, sale, etc. The recipient of the advance also specially binds himself to guard the bank against any loss in connection with the failure to sell, etc. The consignee signs a "letter of lien" or a "letter of trust", which says: "We hereby engage to receive and hold the said goods in trust in your behalf, to have them duly stored, insured against fire, and to remit to you the proceeds as and when sold."

Other Methods of Financing Shipments

Still another method of financing foreign shipments, and one that is more generally used by the London banks, is to permit the shipper to draw on them, promising to accept the draft. In this case the bank must be secured before the maturing date of the acceptance. This method is very advantageous to the exporter because an acceptance by a first class English bank can always be turned into cash at the lowest market rate at once, and for its full amount. The bank is not out any money, and provides for being fully secured before the date when the acceptance has to be taken up. Here the accepting bank acts as an agent for the buyer and takes control of the goods, turning them over against a letter of trust or promissory note, or it stores them at destination and delivers them against the buyer's warrants.

Another phase of this transaction, where the bank authorizes the seller to draw and promises to accept the draft, is the confirmed letter of credit, by which the bank binds itself to accept drafts to a certain stipulated amount.

Chapter III

GERMAN AND FRENCH SYSTEMS OUTLINED

The English system has been outlined in considerable detail because the methods of other countries, especially Germany, have been largely adapted from it. There is not, however, in the English system the extensive ramifications of long-term industrial credits that is found in the German system, which is partly due to the peculiarly intimate connection between banks and industrial enterprises that is characteristic of Germany. While the British over-sea banks and export merchants furnish adequate accommodations to foreign customers, they have shown a consistent tendency to keep down the length of credit terms, preferring—other things being equal—to let the trade go rather than encourage a policy which, from their long experience, they believe to be harmful.

The long-term credits that the Germans were accustomed to extend in Latin America, in the Far East and in other export markets, it is important to note, were not credits given by manufacturers, but by the export merchants with or without the financial assistance of certain banks. The German export merchant, as a rule, purchases from the manufacturer on the basis of making payment within 30 days, the usual stipulation being that he shall have the goods in his possession before settling. There has been a growing tendency of late years, however, to eliminate the export merchant as an economic factor in Germany, and for the manufacturer to do business direct in over-sea markets on a cash or a short-term credit basis. By eliminating interest charges and middlemen's profits, this makes for lower prices.

Operations of the Reichsbank

The great Reichsbank, a private institution, with private means, yet under the control of the State, dominates the German banking system and the German money market. The Reichsbank dictates the discount rate and the rate for loans. The great banks of Germany are in constant intercourse with it, and are the Reichsbank's so-called "giro" customers. "Giro" is a Spanish word, meaning the circulation of specie or bills of exchange, and as used in Germany signifies that in place of making cash payments to one another these banks can use the Reichsbank as a clearing house.

The principal business of the Reichsbank is the discount of short-term bills of exchange, and particularly mercantile bills. Credit and finance bills, as a rule, are excluded from its transactions. The soundness of this practice is obvious. A bill is based upon a real money claim and is, to a certain extent, a security in itself. It is secured by the business capital already employed, and when discounted it discharges the economic function of liquidating that portion of the producer's capital contained in the goods. It releases the fixed capital in the goods and makes it available for another operation. The Reichsbank and the other banks of Germany encourage the use of bills in both internal and foreign transactions, and are themselves large acceptors of bills. Thus, they have become important factors in the development of the great banking system of the Empire.

Bank Acceptances in Germany

In Germany the direct "trade acceptance" has been displaced by the bank acceptance. This is due to the custom of merchants drawing on their bankers instead of on the purchasers of their goods, and using the banker's acceptance in paying their creditors. Most of the German bills are accepted on the basis of their individual credit standing, and not against collateral, as is the case in England. The development of this practice is explained to a certain extent by the large participation of the great banks in a vast number of industrial enterprises. German banks are represented on the boards of directors in numerous undertakings of the most

varied character throughout the Empire, and give them special support in their credit transactions.

In selling a bill of goods the merchant or manufacturer will arrange with his bankers to draw on the latter for the amount, thus anticipating payment for the goods. When so accepted, the bill is sold to other bankers, or in the open market. When thus indorsed, it becomes "prime" paper and eligible for rediscount at the Reichsbank.

All classes of domestic exchanges in Germany are to a large extent adjusted by means of these bank acceptances, which constitute about 80 per cent. of the bills held by banks. The credit standing of the drawee makes the acceptance readily discountable in the private market. The judgment of the market prevents excesses through inflating the acceptance credit. When there is too much of it outstanding, the market reacts. The grantor of the credit, therefore, naturally is careful not to do anything to shake the confidence of the market in himself.

Financing Germany's Oversea Trade

Imports are financed by the banks of Germany in practically the same way as in England, and with similar safeguards. In financing exports, the German merchant, selling on six months' time and wanting immediate cash, does not draw on the over-seas buyer, for that is not in the terms of sale and the draft would not be accepted. The seller arranges with his banker to accept a draft drawn on the strength of the sale. This "banker's acceptance", which is usually drawn for three months, but which may be renewed, is generally at the rate of ¼ of 1 per cent for the three months, to which must be added revenue stamps and brokerage. The exact amount of the acceptance commission is regulated by the desirability of the acceptance as determined by the open discount market.

Bills of Exchange in France

The widespread use of bills of exchange in France is due in a large measure to the liberal policy pursued by the Bank of France in relation to the discount of such paper. Together with gold and

silver, commercial paper forms the basis of the note issue. Commercial paper of a certain quality is interchangeable with bank notes. The Bank of France is a privately owned corporation and, with its nearly 600 branches, covers all France. It opens accounts with anyone known to it, and discounts for anyone who has obtained that right. In the Paris offices a little more than half the paper discounted is for less than 100 francs ($20), and the average term 30 days. The minimum amount of a bill accepted for discount is one dollar (5 francs). Bills, commercial and agricultural warrants of fixed maturity, which have not more than three months to run and bearing three signatures, two of which are of parties domiciled in France and known to be solvent, are freely accepted. Two-name bills are accepted only when accompanied by satisfactory collateral. Warehouse receipts are also received. The private banks lend largely on two-name paper, and by adding their own endorsement make it a three-name paper eligible for rediscount at the central bank. These private banks also discount each other's acceptances. The usual rate for accepting is $\frac{1}{4}$ of 1 per cent for three months; sometimes it is as low as $\frac{3}{16}$.

Acceptances Replace Open Accounts Abroad

From the foregoing necessarily brief outline of the acceptance and draft systems in vogue in the three principal trading and banking countries of Europe it will be seen that in these countries the open account is replaced by the bill of exchange, or time draft. The acceptance, or time bill of exchange, is immediately convertible into cash and, together with the check, forms the perfect medium of large payments, just as the bank note forms the perfect medium of small transactions. Quick redemption, expansion and contraction with the fluctuating needs of business make the check and the bill of exchange ideal credit instruments, for they are both economical and efficient.

Acceptances Superior to Promissory Notes

An acceptance, or time bill of exchange, is superior to a promissory note in having behind it the responsibility of the maker, the responsibility of the acceptor and a specific shipment of goods,

which presumably are to be resold during the life of the instrument and thereby provide means of payment. Abroad these drafts and acceptances circulate from hand to hand exactly as checks do in this country. There is an obvious necessity for meeting them when they fall due, because otherwise the acceptor would soon lose his credit standing and have to go out of business. Furthermore, they provide a complete separation between commercial credits and investment credits which have been so confused under the American method that the distinction is often lost sight of.

Chapter IV

THE AMERICAN CREDIT SYSTEM

The history of bills of exchange in the United States runs back to Colonial times. They were then used for many purposes, but they were mostly devices of the State to be used in lieu of metallic money. They were not true "trade bills", for a comparatively small proportion of them arose from commercial transactions.

After the birth of the United States and up to the Civil War period there was a steady increase in the proportion of this country's business done through the medium of bills drawn by the seller of the goods on the buyer. These "acceptances", as they were called, stood high and played a prominent part in the commercial affairs of the country. Generally speaking, in proportion to the volume of business done, acceptances were then as largely employed as they were in England during that period.

The Civil War, however, brought an aftermath of the wholesale demoralization of credit throughout the United States. Out of this grew the peculiarly American system of cash discounts.

Cash Settlement of Bills

For a number of years after the close of the Civil War credits were uncertain, interest rates were high and the cash settlement of bills was therefore unusually desirable. The cash discount became the customary inducement for the settlement of bills and varied, as it does now, but within wider limits, according to whether payment was spot cash or in ten or thirty days' time. Because of the high interest rates, these cash discounts had to be sufficiently large to spur the buyer to borrow funds and use them for the

prompt settlement of his commercial debts. This method relieved the seller of all responsibility for carrying the account, and therefore was of distinct advantage to him. On the other hand, if a buyer was not able to avail himself of the cash discount, it became a fair assumption that he was not in sufficiently good standing with his bank to be in a position to borrow the money that he needed for that purpose, and this fact cast a certain discredit upon him. Subsequently, as interest rates became less, cash discounts became smaller until, as at present in many lines of trade, the rate of these cash discounts and the bank discount rate approach a parity.

Some Drawbacks of Cash Discounts

Out of this system of cash discounts, however, another evil grew, and one that still prevails. Debtors frequently exceed the discount period as stated on the invoice, and when paying their bills deduct the discount anyway. Sellers, owing to close competition, are often inclined to permit this practice, thus allowing the buyers to gain an unfair advantage not only over their competitors, but also over the sellers themselves. The seller, therefore, is compelled —or at least is tempted—to figure his prices high enough to stand this improper deduction. This, of course, works to the disadvantage of the buyer who scrupulously observes the invoice terms of 30 days net, 2 off 10; or 90 days net, 4 off 30 and 6 off 10, or whatever they may be.

Still another drawback of the cash discount system, as a whole, is that being temporarily unable to discount his bills is an onerous tax on the purchaser of limited means who is thoroughly reliable. In his case, as in the case of others, it is often difficult and inconvenient to make a separate loan to cover each bill or group of bills when they come in. One way of looking at the cash discount is in the light of a fine for letting an account go to maturity. The debtor who does not pay his account when it is due, but lets it go as long as he can without being sued, actually pays no more for his 60 or 90 or 120 days' credit than the one who settles the account on its due date, 10, 15 or 30 days after the date of invoice.

The open account system, on which the cash discount practice rests, is relatively little used in Europe. It is there regarded as a

method by which the slow-paying buyer can use the seller as his involuntary banker without paying for the accommodation and risk. It obviously compels sellers to borrow money against collateral or to strain their credit, and to pay interest without receiving any for the goods lent the seller.

Claims Arising in Settlement of Bills

Still another objection to the open account system is that claims are made at the time of settlement of bills—a constant source of annoyance. A merchant's invoice sold on open account generally states the terms of sale, or the date when that invoice is due and payable. Notwithstanding this, open accounts are practically payable at the will of the debtor. If they are not paid on request, the seller must sue, and must legally swear to the justness of his account and dispute any contention to the contrary. He must be able to prove his account, but before he can do so he runs the risk of counterclaims, setoffs and other troubles that must be contested successfully.

There is nothing to indicate the obligations between the buyer and seller except open accounts on the books of each. If the seller—hopeful man—in anticipation of the settlement of some of his book accounts, wishes accommodation at his bank, he must borrow upon his note. If he uses his credit instead of collateral, he furnishes the bank with a statement of his assets and liabilities. That is all the protection a bank has in such a case. It is but natural, however, that a bank having the accounts of various business houses should feel obliged to extend them certain lines of credit in accordance with their responsibility and borrowing requirements.

Use of Single Name Paper

In recent years it has become customary for merchants presenting good statements of their condition to sell their promissory notes to the public through brokers in commercial paper. These notes are offered to the banks and are largely purchased, ultimately, by investors who wish to find employment for their surplus funds.

A considerable proportion of these notes is single name paper, which is sold solely upon the credit standing of the maker. The only responsibility assumed by the broker is for the genuineness of the signature. When money is easy there is a wide market for this class of commercial paper, but its buyers must depend entirely on such credit information as they can obtain regarding its intrinsic value. These instruments of credit—plain notes of hand—are therefore bought and sold on faith alone. Generally, their makers furnish financial statements only once a year and, naturally, at the period when their business is in the most favorable financial condition. It is, of course, very difficult to ascertain exactly the volume of paper a certain maker may have outstanding at a given time, and there is no indication as to the occasion of its origin.

The use of single name paper dates from the Civil War period. Prior to that time merchandise notes were largely used, running for six months, and even longer. The financial derangements that followed the Civil War, however, increased the uncertainty of value of these long-term credit instruments. The period of credit was shortened and concessions were made for quick settlements.

Single Name Paper Predominates

At present single name paper predominates in the American market. It is estimated by well-informed commercial paper brokers that fully 90 per cent. of the paper traded in is single name. There are several firms that are said to handle more than a hundred millions annually. The trading in commercial paper, up to the present, has been the nearest approach to a discount market here.

While the market for single name paper has been great in volume, it has been restricted in no small degree so that a considerable proportion of it is comprised in notes made by firms of large capital and easily ascertainable credit standing. Some brokers, in fact, will not handle paper of concerns having less than $500,000 assets. This form of borrowing, however, has spread to smaller and weaker concerns.

Chapter V

THE ADVANTAGES OF ACCEPTANCES

The relative advantages and disadvantages of the acceptance form and the practice of borrowing in the open market on single name paper have been the subject of much controversy. It is pointed out, for instance, that it is much simpler for a merchant to sell ten notes of $5,000 each and pay two or three hundred bills with the proceeds—availing himself of the cash discount—that it would be for him to put several hundred trade acceptances into circulation. Obviously, the cost of bookkeeping and collection would be less in the case of the few notes than for the many acceptances. Of course, the seller of the notes has to draw as many checks as he has bills to pay, but the checks are quickly redeemed and pass out of existence. The checks do not involve as much bookkeeping as a similar number of acceptances.

Question of Clerical Work

This question of clerical work concerns the banks also. The average man does not realize the amount of detail involved in the handling of discounts by a bank. There is a manufacturer, for instance, who takes notes in payment of his output and discounts them at several banks. Owing to the large volume of paper that the banks have to handle, he is paying ½ of 1 per cent. of the face value of the notes to cover clerical hire. This just about covers the cost to the banks.

If a business house of large size should make a practice of taking an acceptance for every invoice, or should turn all its open accounts into acceptances once or twice a month, it would naturally

follow that it would give to its bank a thousand different pieces of paper instead of one or two. Under the circumstances, the bank would obviously be justified in making an equitable charge for the extra amount it would have to spend for clerical labor in order to handle the flood of acceptances. On the other hand, the merchant would gain an advantage by using the acceptance instead of the open account system with his customers, and this advantage would more than offset the trifling additional expense of the bookkeeping in the bank and in his own office. In Europe acceptances are used much more freely than checks, and this detail of bookkeeping expense has adjusted itself. In this country, where the check is employed more freely than anywhere else in the world, no doubt the growth of the acceptance system will eventually decrease the volume of checks and thus, through the working out of the old laws of compensation, the clerical question will reach an equilibrium.

Credit Facilities Increased by Acceptances

Another objection to domestic acceptances is based on the ground that their negotiation by the banks in the open market of discount would deprive commercial houses of selling, as heretofore, their own single name notes. It has been a common banking experience, however, that the open market of discount for bank acceptances is entirely separate from, and does not interfere with, the discount of single name commercial paper, which will continue to be handled on the same basis as before bank acceptances came into existence. Banks having surplus funds to invest will always be attracted by the commercial paper of a responsible house. Instead of curtailing their facilities, bank acceptances may, on the contrary, enlarge the financial accommodations put at the disposal of reliable firms and corporations. For example, a bank or discount house may purchase the single name notes of a certain concern up to $50,000; this transaction will not prevent the same bank from purchasing even a large amount of bills drawn by the same firm and accepted by responsible banks, the liability and credit of which will mostly be taken into consideration in this second transaction.

The tendency of trade acceptances, therefore, is toward increasing a merchant's banking facilities. As it is now, the merchant

makes an arrangement with his bank for a certain line of credit. As a rule, the basis of this is his statement, which includes accounts receivable of whose nature the banker knows nothing, unless the merchant has gone so far—which is unusual—as to have his business thoroughly examined and audited by a certified public accountant who reports not only on the arithmetic of the business, but also as to the character and soundness of all its resources. On the other hand, acceptances indicate the class of trade a merchant is dealing with. In other words, it enables the bank to check up the acceptor. The banker is primarily a dealer in credit, and it is to him the public looks to keep the credit machine in good order. The acceptance system helps the banker to keep sound the credit structure over which he presides.

Acceptances and Cash Discounts

Trade acceptances need not interfere with cash discounts. If an invoice were paid in ten days, with a deduction of the cash discount, the acceptance could be returned unsigned, accompanied by the check in settlement of the bill that the acceptance covered. Or, if it should be found desirable to anticipate maturities after acceptances had been signed, the bank, if it desired to aid in creating acceptances, would be willing to rebate the interest for the unexpired time. This is a common practice with foreign acceptances where documents are attached and only deliverable on payment of the draft. Such drafts are drawn at 60 or 90 days' sight, with the understanding that if the acceptor desires to take up the draft and papers prior to maturity, the interest will be rebated proportionately.

Acceptances Not Detrimental to Credit System

Another objection that has been urged against acceptances is that they would prove a detriment to the credit system.

For the sake of argument, say those who regard acceptances as undesirable from that point of view, let us take the case of a small manufacturer—in the cloak and suit business, for example. His business represents a $10,000 investment. His assets consist of outstanding accounts, $5,000; merchandise, $2,800; cash, $1,000, and fix-

tures, $1,200. He owes $4,000 to merchandise creditors. He is doing a business of $50,000 a year, and makes a fair profit. The trade acceptance idea strikes him favorably, and he takes acceptances for the goods he sells, receiving them on the delivery of the merchandise. He suddenly awakens to the fact that he has $5,000 worth of negotiable paper on hand, instead of that much in open accounts outstanding. He borrows money from the bank on these acceptances. He begins to see possibilities of doubling or even trebling his profits if he can get enough cash to operate with. He has no excess orders on hand, nor are there any in sight to warrant his expansion. He takes the $5,000 he has received for his acceptances and buys more merchandise, increasing his liabilities. He moves into larger quarters and adds to his overhead expense.

Result of Unwarranted Expansion

Meanwhile, the orders have not been coming in as fast as he expected or hoped, and he realizes that he is overstocked. He becomes alarmed and begins sacrificing his merchandise, with the result that he soon finds himself a heavy loser. His notes are falling due and he cannot meet them. A meeting of his creditors is called. The bank is not particularly interested, for it is well secured and is not likely to lose anything. Other creditors settle for about 30 cents on the dollar. If the manufacturer had not been able to hypothecate his outstanding accounts, say those who argue along this line, he would not have failed.

That such an argument is fundamentally wrong, and that it is the man and not the system that is to blame, will be obvious to anyone who considers this hypothetical case. The manufacturer, of course, should have used the $5,000 he realized from his acceptances to pay his $4,000 outstanding debts, thus strengthening his credit standing. With the $1,000 balance he could have safely bought more merchandise without overstocking. It was the course that he followed—not the manner in which he obtained the money—that led to his financial downfall.

One of the duties of every merchant or credit man is to guard against things of this sort—to prevent unwarranted expansion by refusing to sell larger quantities of merchandise unless the pros-

pective buyer can produce definite evidence that enlargement is justified.

Trade Acceptance Aid to Sound Banking

In the discount markets of Europe the volume of acceptances put forth by every individual, firm or corporation is closely watched and every attempt at over-expansion is checked by the market itself. A man whose bills are regarded as having reached the safe maximum indicated by the size and character of his business, soon finds that if he tries to exceed his limit, as set by the general judgment of others, there are fewer and fewer buyers for his acceptances. In fact, the volume of credit and its intrinsic worth is regulated by the banker, who, as a governor of credit, can control both the quantity and the quality. The particular function of banking in connection with acceptances and other kinds of commercial paper is to collect the various obligations and "clear" the transactions as the clearing house clears checks. Debtors and creditors are constantly trying to get together and write off their obligations against each other. The trade acceptance, as it affords the banker a check on both the buyer and the seller, is a far greater aid to sound banking than the promissory note, and with this new credit instrument the American banker will be able to safeguard, as never before, the interests of his clients, as well as his own.

Conservatism in Granting Credit

There is every reason to believe that a number of business men are anticipating that the trade acceptance will bring them a larger line of credit at their bank. This is probably true. It is safe to assume, however, that the banks will continue a conservative course. and very little danger is to be expected from this source. Trading and kiting on the part of men operating without sufficient capital cannot be eliminated. No doubt, as the acceptance system becomes more widely used, there will be many cases where credit will be extended for the purpose of securing acceptances in the hope of being able to find a market for them, just as there are cases where houses sell their accounts receivable and become loose in their credits simply because they have a market for their receivables, thus eventually meeting with disaster.

Chapter VI

REGULATIONS OF FEDERAL RESERVE BOARD

The text of the regulations as issued by the Federal Reserve Board, up to the present writing, relating to commercial paper, is of vital interest to merchants and manufacturers, as well as to bankers. A part of Section 13 of the Federal Reserve Act reads as follows:

> "Upon the endorsement of any of its member banks, with a waiver of demand notice and protest by such bank, any Federal reserve bank may discount notes, drafts and bills of exchange arising out of actual commercial transactions; that is, notes, drafts and bills of exchange issued or drawn for agricultural, industrial or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act. Nothing in this Act contained shall be construed to prohibit such notes, drafts and bills of exchange, secured by staple agricultural products, or other goods, wares or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying on or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. Notes, drafts and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety days: Provided, That notes, drafts and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months may be discounted in an amount to be limited to the percentage of the capital of the Federal Reserve Bank, to be ascertained and fixed by the Federal Reserve Board.

"Any Federal reserve bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity at time of discount of not more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid-up capital stock and surplus of the bank for which the rediscounts are made.

"The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm or corporation, rediscounted for any one bank shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values.

"Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months' sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half its paid-up capital stock and surplus . . .

"The rediscount by any Federal reserve bank of any bills receivable and of domestic and foreign bills of exchange and of acceptances authorized by this Act shall be subject to such restrictions, limitations and regulations as may be imposed by the Federal Reserve Board.

"Section 14. Any Federal reserve bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations or individuals, cable transfers and bankers' acceptances and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank.

"Every Federal reserve bank shall have the power: . .

"(c) To purchase from member banks and to sell, with or without its indorsement, bills of exchange arising out of commercial transactions as hereinbefore defined;

"(d) To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business;

"(e) To establish accounts with other Federal reserve banks for exchange purposes, and, with the consent of the Federal Reserve Board, to open and maintain banking accounts in foreign countries, appoint correspondents and establish

agencies in such countries wheresoever it may deem best for the purpose of purchasing, selling and collecting bills of exchange, and to buy and sell, with or without its indorsement, through such correspondents or agencies, bills of exchange arising out of actual commercial transactions which have not more than ninety days to run and which bear the signature of two or more responsible parties."

Powers of New York State Banks

In order that banks and trust companies in New York State may have similar powers, the revised banking law of the state permits a state bank or trust company to accept for payment at a future date, drafts drawn upon it by its customers and to issue letters of credit authorizing the holders thereof to draw drafts upon it or its correspondents at sight or on time, not exceeding one year.

Under the New York Act there are no restrictions as to the origin of the paper. New York State banks are not limited as to the amount of acceptances they may make in total, although they are not allowed to loan by way of any extension of credit, by means of letters of credit or by acceptances, more than one-tenth part of the capital and surplus to any individual, partnership, corporation or unincorporated association, etc. Banks in the Federal Reserve System may not accept paper running longer than six months, while New York State banks may accept up to one year.

Desirability of Bills of Exchange

From the foregoing quotation from the Federal Reserve Act it will be seen that one of its most valuable features is its rehabilitation of bills of exchange by the establishment of rediscount facilities. It places the banking system of the United States on a similar basis to that of other civilized countries that make prime commercial paper the foundation of their loan business. In its interpretations of the Act, the Federal Reserve Board has materially assisted in the movement to educate American commerce to use the bill of exchange even in small transactions.

The first regulations of this Board, issued November 10, 1914,

outlining its discount policy, are evidence of such intention. Under the heading "Commercial Paper", paragraph C, the Board says:

> "Bills should be essentially self-liquidating. Safety requires not only that bills held by the Federal reserve banks should be of short and well-distributed maturities, but, in addition, should be of such character that it is reasonably certain that they can be collected when they mature. They ought to be essentially 'self-liquidating', or, in other words, should represent in every case some distinct step or stage in the productive or distributive process—the progression of goods from producer to consumer. The more nearly these steps approach the final consumer, the smaller will be the amount involved in each transaction as represented by the bill, and the more automatically self-liquidating will be its character."

The last sentence is particularly significant as applying even to the retail trade. Again, the Board points out its preference for bills of exchange as against ordinary notes of hand.

> "Double name paper drawn on a purchase against an actual sale of goods affords, from an economic point of view, prima facie evidence of the character of the transaction from which it arose. Single name notes, now so freely used in the United States, may represent the same kind of transactions as those bearing two names. Inasmuch, however, as the single name paper does not show on its face the character of the transaction out of which it arose—an admitted weakness of this form of paper—it is incumbent upon each Federal reserve bank to insist that the character of the business and the general status of the concern supplying such paper should be carefully examined in order that the discounting bank may be certain that no such single name paper has been issued for purposes excluded by the Act, such as investments of a permanent or speculative nature. Only careful inquiry on these points will render it safe and proper for a Federal reserve bank to consider such paper a 'self-liquidating' investment at maturity."

Scope of Acceptances Extended

Thus, the Board clearly places a premium on bills of exchange, and indicates their great desirability.

The Federal Reserve Board, under date of April 2, 1915, (Circular No. 11), went still further and said, in part:

"It is believed that it would unduly restrict the development of the acceptance business to keep it altogether confined within the provisions of Section 13, which requires that acceptances, in order to be eligible for rediscount at a Federal reserve bank, must bear the indorsement of a member bank; particularly in view of the further fact that the law limits the amount of acceptances which may be taken with the indorsement of a member bank to 50 per centum of its paid-in capital and surplus. Having found it necessary to extend the scope of dealings in acceptances beyond these limits, the Board has exercised the authority conferred upon it by Section 14, and has formulated regulations covering the purchase of acceptances without invariably requiring the indorsement of a member bank.

"The acceptance is the standard form of paper in the world discount market, and both on this account and because of its acknowledged liquidity universally commands a preferential rate. By reason of its being readily marketable it is widely regarded as a most desirable paper in the secondary reserves of banks and will help to provide an effective substitute for the 'call loan.' Its growth, however, will depend upon the ability of the American market to adjust its rates effectively to those prevailing in other markets for paper of this class.

"Recognizing these facts, the Federal Reserve Board has determined to allow the Federal reserve banks latitude in fixing rates for acceptances: Federal reserve banks may, from time to time, submit for the approval of the Board maximum and minimum rates within which they desire to be authorized to deal in acceptances; within such limits and subject to such modifications as may be imposed by the Board, Federal reserve banks will be allowed to establish the rates at which they will deal in acceptances.

"The Board believes it to be in accordance with the spirit of the Act to accord preferential treatment to acceptances bearing the indorsement of member banks, offered for rediscount under Section 13—even to the point of allowing lower rates for such acceptances, inasmuch as under the terms of this Section, such acceptances are available as collateral against the issue of Federal reserve notes; and the Board will sanction a slight preferential in favor of acceptances bearing the indorsement of member banks.

"When acceptances bearing the indorsement of member banks are not obtainable in adequate amount or upon satisfactory terms, Federal reserve banks desiring to purchase acceptances should restrict themselves as far as possible to such acceptances as bear some other responsible signature (other than that of the drawer and acceptor) and preferably that of a bank or banker."

Regulations on Bankers' Acceptances

The regulations of the Board on banker's acceptance follows:

"In this regulation the term 'acceptance' is defined as a draft or bill of exchange drawn to order, having a definite maturity and payable in dollars in the United States, the obligation to pay which has been accepted by an acknowledgment written or stamped and signed across the face of the instrument by the party on whom it is drawn; such agreement to be to the effect that the acceptor will pay at maturity according to the tenor of such draft or bill without qualifying conditions.

"The Federal Reserve Board has determined that, until further order, to be eligible for discount under Section 13 by Federal reserve banks at rates to be established for bankers' acceptances: . . . .

"Acceptances must have been made by a member bank, non-member bank, trust company, or by some private banking firm, person, company or corporation engaged in the business of accepting or discounting. Such acceptances will hereafter be referred to as 'bankers' acceptances';

"A banker's acceptance must be drawn by a commercial, industrial or agricultural concern (that is, some person, firm, company or corporation) directly connected with the importation or exportation of the goods involved in the transaction in which the acceptance originated, or by a 'banker'. In the latter case, the goods, the importation or exportation or which is to be financed by the acceptance, must be clearly specified in the agreement with or the letter of advice to the acceptor. The bill must not be drawn or renewed after the goods have been surrendered to the purchaser or consignee.

"A 'banker's' acceptance must bear on its face, or be accompanied by evidence in the form satisfactory to a Federal reserve bank, that it originated in actual bona fide sale or consignment involving the importation or exportation of goods. Such evidence may consist of a certificate on or accompanying the acceptance to the following effect:

'This acceptance is based upon a transaction involving the importation or exportation of goods. Reference No. —. Name of Acceptor ———'

"Bankers' acceptances, other than those of member banks, shall be eligible only after the acceptors shall have agreed in writing to furnish to the Federal reserve banks of the respective districts, upon request, information concerning the nature of the transactions against which acceptances have been made.

"A bill of exchange accepted by a 'banker' may be considered as drawn in good faith against 'actually existing values',

when it is secured by a lien on or by transfer of title to the goods to be transported; or in case of release of the goods before payment of the acceptance by the substitution of other adequate security.

"Except in so far as they may be secured by a lien on or by transfer of the title to the goods to be transported, the bills of any person, firm, company, or corporation, drawn on and accepted by any private banking firm, person, or corporation (other than a bank or trust company) engaged in the business of discounting or accepting, and discounted by a Federal reserve bank, shall at no time exceed in the aggregate a sum equal to five per centum of the paid in capital of such Federal reserve bank.

"The aggregate of acceptances of any private banking firm, person, company, or corporation (other than a bank or trust company) engaged in the business of discounting or accepting, discounted or purchased by a Federal reserve bank, shall at no time exceed a sum equal to twenty-five per centum of the paid-in capital of such Federal reserve bank . . . .

"While it would appear impracticable to fix a maximum sum or percentage up to which Federal reserve banks may invest in bankers' acceptances, both under Section 13 and Section 14, it will be necessary to watch carefully the aggregate amount to be held from time to time. In framing their policy with respect to transactions in acceptances, Federal reserve banks will have to consider not only the local demands to be expected from their own members, but also requirements to be met in other districts. The plan to be followed must in each case adapt itself to the constantly varying needs of the country . ."

Final Definition of Trade Acceptance

When the Federal Reserve Board, on July 15th, promulgated Circular No. 16 (Regulation P) Series of 1915, it became evident that the regulation issued in November, 1914, previously referred to, was really to prepare the way for the final definition of "Trade Acceptances". Other rulings also pointed out that eventually double name paper would be shown preference. This was finally demonstrated when the Board approved a rate for trade acceptances of one-half of one per cent. below the regular discount rate. The significance of this material variation in the rate is apparent, as it was originally proposed to fix "a slightly lower rate" for two name paper than for single name notes.

"Regulation P", of July 15, 1915, is as follows:

"In this regulation the term 'trade acceptance' is defined as a bill of exchange of the character hereinafter described, drawn to order, having a definite maturity and payable in dollars in the United States, the obligation to pay which has been accepted by an acknowledgment, written or stamped, and signed, across the face of the instrument, by the company, firm, corporation, or person upon whom it is drawn; such agreement to be to the effect that the acceptor will pay at maturity, according to its tenor, such draft or bill without qualifying conditions.

"A trade acceptance to be eligible for rediscount, under Section 13, with a Federal reserve bank at the rate to be established for trade acceptances

(a) Must be indorsed by a member bank, accompanied by waiver of demand notice and protest.

(b) Must have a maturity at the time of discount of not more than 90 days.

(c) Must be accepted by the purchaser of goods sold to him by the drawer of the bill and the bill must have been drawn against indebtedness expressly incurred by the acceptor in the purchase of such goods.

"A trade acceptance must bear on its face, or be accompanied by, evidence in form satisfactory to the Federal reserve bank, that it was drawn by the seller of the goods on the purchaser of such goods. Such evidence may consist of a certificate on or accompanying the acceptance, to the following effect: 'The obligation of the acceptor of this bill arises out of the purchase of goods from the drawer.' Such certificate may be accepted by the Federal reserve bank as sufficient evidence; provided, however, that the Federal reserve bank, in its discretion, may inquire into the exact nature of the transaction underlying the acceptance."

Origin of Bankers' Acceptances

In regulation R, Series of 1915, relating to the discount of bankers' acceptances, the Federal Reserve Board provided for the purchase in the open market of bankers' acceptances based on the importation or exportation of goods. The Board further stated that it had not felt justified, when admitting State banks and trust companies into the Federal Reserve System, in stipulating that such domestic acceptances should not be continued under reasonable limitations as a part of their business.

Inasmuch as the making of these acceptances has been recognized by the Board as the exercise of a legitimate banking function when authorized by law, it is thought that they are of the character to make desirable investments for Federal Reserve banks. The Board therefore issued a new regulation, not only embodying the authority given in Regulation R, Series of 1915, to purchase bankers' acceptances based on the importation or exportation of goods, but also authorizing the purchase of bankers' domestic acceptances within the limits prescribed in the regulation, which provides:

> "The Federal Reserve Board has determined that, until further notice, to be eligible for purchase under Section 14 at the rates to be established for the purchase of bankers' domestic and foreign acceptances:
>
> "(a) Acceptances must have been made by a bank or trust company, or by some firm, person, company, or corporation engaged in the business of accepting or discounting. Such acceptances will hereafter be referred to as 'bankers' acceptances';
>
> "(b) A banker's acceptance must be drawn by a purchaser or seller or other person, firm, company, or corporation directly connected with the importation or exportation of the goods involved in the transaction in which the acceptance originated, or by a 'banker'. The bill must not be renewed after the goods have been surrendered to the purchaser or consignee, except for such reasonable period as may have been agreed upon at the time of the opening of the credit as a condition incidental to the importation or exportation involved, provided that the bill must not contain or be subject to any condition whereby the holder thereof is obligated to renew the same at maturity.
>
> "(c) A banker's foreign acceptance must bear on its face or be accompanied by evidence in form satisfactory to a Federal reserve bank that it originated in, or is based upon, a transaction or transactions involving the importation or exportation of goods. Such evidence may consist of a certificate on or accompanying the acceptance to the following effect: 'This acceptance is based upon a transaction involving the importation or exportation of goods. Reference No.—. Name of Acceptor—.'
>
> "(d) A banker's domestic acceptance must be based on a transaction covering the shipment of goods, such transaction to be evidenced at the time of acceptance by accompanying shipping documents, or must be secured by a warehouse receipt covering readily marketable staples and issued by a warehouse independent of the borrower; or by the pledge of goods actually sold;

" (e) A banker's domestic acceptance must bear on its face or be accompanied by evidence in form satisfactory to the Federal reserve bank that it is based on a transaction or is secured by a receipt or pledge of the character defined in (d) hereof. Such evidence may consist of a certificate in general form similar to that suggested in (c) hereof;

" (f) Banker's acceptances, other than those of member banks, whether foreign or domestic, shall be eligible only after the acceptors shall have agreed in writing to furnish to the Federal reserve banks of their respective districts, upon request, information concerning the nature of the transactions against which acceptances (certified or bearing evidence under (c) and (e) hereof) have been made;

" (g) The aggregate of bills, domestic and foreign, of any one drawer, drawn on and accepted by any bank or trust company and purchased or discounted by a Federal reserve bank, shall at no time exceed 10 per cent. of the unimpaired capital and surplus of such bank or trust company, but this restriction shall not apply to the purchase or discount of bills drawn in good faith against actually existing values; that is, bills the acceptor of which is secured by a lien on or by a transfer of title to the goods to be transported, or by other adequate security, such as a warehouse receipt, or the pledge of goods actually sold.

" (h) The aggregate of bills, domestic and foreign, of any one drawer, drawn on and accepted by any firm, person, company or corporation (other than a bank or trust company) engaged in the business of discounting or accepting, and purchased or discounted by a Federal reserve bank, shall at no time exceed a sum equal to a definite percentage of the paid-in capital of such Federal reserve bank, such percentage to be fixed from time to time by the Federal Reserve Board; but this restriction shall not apply to the purchase or discount of bills drawn in good faith against actually existing values; that is, bills the acceptor of which is secured by a lien on or by a transfer of title to the goods to be transported or by other adequate security, such as a warehouse receipt, or the pledge of goods actually sold;

" (i) The aggregate of bankers' acceptances, domestic and foreign, made by any one firm, person, company, or corporation (other than a bank or trust company) engaged in the business of discounting or accepting, purchased or discounted by a Federal reserve bank, shall at no time exceed a sum equal to a definite percentage of the paid-in capital of such Federal reserve bank; such percentage to be fixed from time to time by the Federal Reserve Board.

"No Federal reserve bank shall purchase a domestic or foreign acceptance of a 'banker' other than a member bank which does not bear the indorsement of a member bank, unless there is furnished a satisfactory statement of the financial condition of the acceptor in form to be approved by the Federal Reserve Board.

"Federal reserve banks should bear in mind that preference should be given wherever possible to acceptances indorsed by a member bank, discounted under Section 13, not only because of the additional protection that such indorsement affords, but also because of the reason that acceptances discounted under Section 13 may be used as collateral security for the issue of Federal reserve notes."

Preferential Rate on Acceptances

From the foregoing it will be noted that the desire of the Federal Reserve Board is to establish a class of paper which will, as surely as possible, bear on its face the fact that it is used in connection with a genuine commercial transaction, that the proceeds are to be used in the producing, carrying or marketing of goods, in one or more steps of production, manufacture and distribution, and feeling that the trade acceptance or domestic bill of exchange is most easily identified on its face with such a transaction, permits a preference thereon by a slightly lower rate when a reserve bank rediscounts or purchases same in the open market.

Single Name Paper Eligible for Rediscount

This does not mean that any doubt should be cast upon single name paper, which heretofore has occupied the discount market. It, too, is eligible for rediscount by the Federal Reserve banks if accompanied by satisfactory evidence that the proceeds were used, or were to be used, as specified, for strictly commercial purposes. Single name paper does not, of course, on its face, move parallel to or along with commercial transactions as the trade acceptance does, yet the vast bulk of single name paper has always fallen under the definition of that class of paper eligible under the Federal Reserve Act and rulings established by the Federal Reserve Board.

Each piece of paper, whether it be single or double name, must

be examined to discover its peculiar merits. The mere fact that the paper contains two names does not, of course, alone make it preferable to a single name note, but from the point of view of the Federal Reserve Board, does have an advantage in its almost self-evident relationship with that form of commercial transaction defined in the Act.

Checking Tendency Toward Over-Expansion

It is also quite apparent that the Federal Reserve Board will not countenance any laxity on the part of the Federal Reserve banks in rediscounting or buying.acceptances in the open market. Proper evidence of the responsibility of the acceptor will always be necessary when the paper is bought in the open market, and if discounted in behalf of a member bank, will be subjected to the same sort of examination as single name paper. This, in itself, is likely to prove an effective check on any efforts toward over-expansion on the part of the drawers of acceptances or notes. It is a matter of credit in each case.

Chapter VII

DEVELOPING THE MARKET FOR ACCEPTANCES

The market for acceptances in this country is still in its infancy, but the indications are that its development will be rapid and along the lines of the great discount centers of Europe. In London, Paris and Berlin the eyes of the financial community are always closely fixed on the discount rate. In New York, up to the time acceptances began to be traded in, the governing rate was for day-to-day loans on the Stock Exchange. The disadvantage of this, as compared with the European system and with the Federal Reserve System, is that the latter bear a very decided relation to trade conditions. The fluctuations of the market for acceptances and bills of exchange generally depend primarily on the demand for and the supply of bills which owe their origin to trade transactions, as balanced against the demand for and the supply of money. If trade is active, the supply of bills becomes large and the absorption of loanable funds of the banks is rapid. As these surplus funds become less and less, the discount rate advances. If trade is slack, acceptances become fewer, the competition for them in the discount market is more keen and the rate of discount declines. Low rates are an incentive to business, and advancing rates act as a natural check. The New York call loan rate, on the other hand, bears only an indirect relation to trade conditions, as it registers mainly the speculative and investment demand for stocks. Call loan rates are subject to violent fluctuations, while discount rates for bills are comparatively stable.

Report of New York Federal Reserve Bank

The first annual report of the Federal Reserve Bank of New York, covering a period of about fifteen months, or from October 5, 1914, to the close of business, December 31, 1915, discusses from the viewpoint of experience the working out of the Act as regards acceptances. It says:

"The influence of this bank on interest rates and the expansion and contraction of credits is likely to be exercised more through its open market operations than through the rediscounts of the member banks, or of other Federal reserve banks . . . It should be the policy of reserve banks to maintain a fairly stable rate on such paper (bankers' acceptances and other bills purchased in the open market). Then in times of expansion or demand for credit, when market rates rise above theirs, such paper will flow into them in substantial volume and the gold released in payment will find its way into the reserves of member and other banks, increasing their credit power and checking extreme advances in rates. In times of contraction or abundant credit, when market rates fall below those of the reserve banks, the investments of the latter will be absorbed as they mature, by banks and other institutions, thereby transferring gold from their reserves to the reserve banks, reducing the credit power of the member banks and checking extreme declines in rates.

"Similarly, if a sufficient volume of bankers' acceptances based on imports and exports is developed to create a stable discount market in New York or elsewhere, in the United States, an international ebb and flow may be effected. When the dollar acceptance reaches a degree of currency comparable with that of the sterling acceptance, its use will depend largely upon whether, on arrival in New York, it can be discounted at a rate lower than the rate for sterling acceptances in London. Those engaged in international business will draw on the city where their drafts can be discounted at the lowest rate . .

"Through the creation of the bankers' acceptance an international credit instrument has been introduced into our banking system which, when developed, is likely to prove a potent influence in regulating the flow of credit between Europe and America. It should enable America, in normal times, to regulate its credit position primarily by recourse to the European market, thereby rendering domestic rate fluctuations less violent. Greater stabilization of interest rates is one of the most